United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

ORIGINAL

76-7270

United States Court of Appeals
For The Second Circuit

Docket No. 76-7270

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SOPHIE RUSKAY *et al.*,
Plaintiffs-Appellants,

P/S

versus

CHAUNCEY L. WADDELL *et al.*,
Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR PLAINTIFFS-APPELLANTS

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The plaintiffs in these four consolidated stockholders' derivative actions appeal from a final judgment of the District Court for Southern New York (A450) summarily dismissing plaintiffs' claims on the grounds of res judicata and release. The opinion below (A441), by Metzner, J., is reported, Ruskay v. Jensen, 342 F. Supp. 264 (S.D.N.Y. 1972).

THE ISSUE PRESENTED.

Are these actions barred by res judicata and release? The answer depends on several subsidiary questions, whose presentation requires a brief summary of the case.

THE NATURE OF THE CONTROVERSY.

Plaintiffs, as stockholders of defendant United Funds, Inc. (the "Fund"), a registered mutual fund, bring these actions against its directors, against Waddell & Reed, Inc. ("W&R"), the Fund's investment adviser and principal underwriter, and against the principal

stockholders of W&R. In 1969 the W&R stockholders, including three of the individual defendants, sold the stock of W&R to a new owner at a price vastly in excess of asset value. Under the Investment Company Act (the "Act"), the sale automatically terminated the Fund's advisory and underwriting agreements with W&R (the "service agreements"). Since these agreements were the principal source of W&R's income, the parties to the sale conditioned their contract upon the reinstatement of the service agreements by the stockholders and directors of the Fund; the sellers and the management of the Fund agreed to and did procure their reinstatement. Plaintiffs charge that the transaction constituted a sale of W&R's advisory and underwriting offices, and they seek to recover the excess of the sales price over the asset value of the stock under the principles of Rosenfeld v. Black, 445 F. 2d 1337 (2d Cir. 1971), cert. dismissed, 409 U.S. 802 (1972).

Defendants contend, and the Court below held, that this claim is precluded by a judgment and release issued in two earlier derivative actions brought by stockholders of the Fund (the "Horenstein-Ruskay actions", more fully described below). Commenced in 1967 and early 1969, these actions charged that a subsidiary of W&R, acting as stock broker for the Fund, had engaged in improper brokerage practices yielding large illegal profits to W&R and its subsidiary at the expense of the Fund. When the proposed sale of W&R's stock was announced in 1969, the Horenstein-Ruskay plaintiffs secured leave to file supplemental complaints alleging that part of the

sales price was an outgrowth and, in effect, a capitalization of W&R's illegal brokerage profits and should, therefore, be impressed with a trust for the Fund. The Horenstein-Ruskay supplemental complaints did not, however, charge that the 1969 transaction was a sale of W&R's advisory and underwriting offices, nor did they allege the facts necessary to support such a charge.

Ultimately, the Horenstein-Ruskay actions were consolidated and settled with court approval pursuant to FRCP 23.1. Neither the settlement notice to the stockholders of the Fund nor the court's decision approving the settlement suggested that a claim for the sale of the advisory and underwriting offices was alleged or was to be included in the settlement. The judgment and release issued pursuant to this settlement are the basis on which the present actions were dismissed.

Several rules of law bear on the controversy.

1. A judgment in a prior action bars a second suit only if that suit is on "the same cause of action" as the first. Commissioner v. Sunnen, 333 U.S. 591, 597 (1948); Herendeen v. Champion International Corp., 525 F. 2d 130, 133-35 (2d Cir. 1975). Hence the question:

> Is the present claim for sale of the advisory and underwriting offices "the same" as the Horenstein-Ruskay claim for illegal brokerage practices?

We submit, contrary to the Court below, that the claims are not "the same". But even if they are, res judicata fails for additional reasons.

2. Where the claims in the first and second actions are "the same", the prior judgment ordinarily operates as a bar even though the two suits are based on different grounds (as where the first action is based on tort, the second on breach of contract). A plaintiff, in other words, cannot "split" a single cause of action by reserving one of the grounds for a later suit. However, the prior judgment is not a bar if, for one reason or another, the ground asserted in the second action could not have been advanced in the first. Burns Bros. v. Central Railroad of New Jersey, 202 F. 2d 910, 913-14 (2d Cir. 1953); Taylor v. Continental Supply Co., 16 F. 2d 578, 581-82 (8th Cir. 1926). Here, the sale of office occurred after the commencement of Horenstein-Ruskay; it could, therefore, have been alleged only by supplemental complaint and only with the Court's permission, FRCP 15(d). There is no evidence that the permission, if sought, would have been granted; the indications are to the contrary. The burden of proving that Horenstein and Ruskay could have secured leave to plead the sale of office rests upon defendants as the parties invoking res judicata; Burns Bros., supra. Hence the second question here is:

Assuming that the claims here and in Horenstein-Ruskay are "the same", can defendants prove that the

Horenstein-Ruskay plaintiffs would, upon request, have been granted the District Court's discretionary permission to plead the sale of office by way of supplemental complaint?

We submit that such proof is impossible; Burns Bros., supra. The sale-of-office claim is, therefore, not barred by the Horenstein-Ruskay judgment. This point was urged on the Court below, but its decision ignored it.

3. The judicially approved settlement or dismissal of a derivative action binds non-party stockholders only if they received adequate notice of the proposed settlement or dismissal. Smith v. Alleghany Corp., 394 F. 2d 381, 391 (2d Cir.), cert. denied, 393 U.S. 939 (1968); Papilsky v. Berndt, 466 F. 2d 251, 256-59 (2d Cir.), cert. denied, 409 U.S. 1077 (1972). Hence these further questions arise:

Did the Horenstein-Ruskay settlement notice adequately inform the stockholders that a claim for the sale of W&R's offices was to be settled? If not, does the lack of adequate notice prevent the plea of res judicata?

These questions, too, were urged on the Court below, but were ignored by its decision.

4. The release executed by the Fund in Horenstein-Ruskay comprised, by its terms, all claims of the Fund arising from any "matters or transactions recited or described in the [pleadings]

filed by the plaintiffs in the [Horenstein-Ruskay] actions" (A234-35). Hence these further questions arise:

> Was the sale of W&R's offices "recited or described" in the pleadings of the Horenstein-Ruskay plaintiffs? Even if it was, can the effect of the release go beyond the scope of the Horenstein-Ruskay settlement notice?

These questions were likewise urged on the Court below, but were ignored by its decision.

STATEMENT OF THE CASE

1. Jurisdiction and proceedings.

This Court's jurisdiction rests on 28 USC § 1291. The judgment below (A450), containing a Rule 54(b) recital, was entered May 7, 1976. Plaintiffs' notice of appeal was filed June 4, 1976 (A457).

The District Court's jurisdiction rested on § 44 of the Act, 15 USC § 80a-43, and the principles of pendent jurisdiction (A 1-2). The four actions were commenced between July and October, 1971 (A71-73) and were thereafter consolidated. On March 25, 1972, Judge Metzner granted defendants' motions for summary judgment to the extent of dismissing the sale-of-office claim (A441). Various other claims - along with the claims in yet a fifth action subsequently consolidated with the first four - were settled and were dismissed by judgment of March 22, 1976. The judgment expressly preserved the sale-of-office claim, except that it dismissed so

much thereof as was directed against the purchaser of the W&R stock (Continental Investment Corporation), its directors and officers. This partial judgment is not involved in the appeal. A second judgment, however, entered May 7, 1976 on Judge Metzner's decision, is the subject of the present appeal (A450, 457).

Several defendants having been eliminated from the case, only the following are now before the Court: the Fund, Waddell & Reed (a New York corporation, called W&R/NY), its successor by merger likewise named Waddell & Reed (a Massachusetts corporation, called W&R/Mass), and four individuals, Waddell, Merriman, Roach and Valicenti.

2. <u>The present complaints</u>.

So far as here relevant, the four complaints (A1, 18, 27, 46) are similar. Since their allegations are not questioned by defendants' motions (A62, 270), they must, for present purposes, be accepted as true.

As noted, plaintiffs were and are stockholders of the Fund, an open-end management investment company or mutual fund registered with the SEC under the Act. In 1969, the Fund had net assets of about two billion dollars and about 500,000 stockholders (A2-3).

W&R/NY acted as the Fund's investment adviser and principal underwriter pursuant to agreements, under which it drew advisory fees of more than eight to nine million dollars per year, in addition to substantial commissions for selling the shares of the

Fund. W&R's net assets were about $18 million, equal to $18 per share. Defendants Waddell, Merriman, Roach and Valicenti were directors of both the Fund and W&R and were the principal officers and counsel of both companies. Except for Valicenti, the same men were substantial stockholders of W&R (A3-6).

In March 1969, the major stockholders of W&R, including Waddell, Merriman and Roach, entered into a contract with Continental Investment Corporation for the sale to Continental, at $80 per share, of all the W&R stock owned by the selling stockholders (the "Continental Contract"). Continental undertook to make a tender offer, at $80 per share, for the remaining stock of W&R (A6-7).

By virtue of §§ 15, 2(a)(4) and 2(a)(9) of the Act (quoted p. 48 , below), the consummation of the Continental Contract was bound to result in the automatic termination of the advisory and underwriting agreements. These "service agreements" were the principal source of W&R's income; without them, the W&R stock, having an asset value of only $18 a share, could not have been sold at $80. Accordingly, the Continental Contract was, by its terms, conditioned upon the reinstatement of the advisory agreement by the stockholders, and of the underwriting agreement by the directors of the Fund. The parties to the Continental Contract and W&R were to use their best efforts to secure the reinstatement (A6-8).

Pursuant to this understanding, defendants caused the Fund to call a stockholders' meeting to pass on the reinstatement of the advisory agreement. The management of the Fund recommended the reinstatement. The cost of the proxy solicitation was borne by W&R. On June 3, 1969, the stockholders approved the reinstatement. On the same day, the directors approved the reinstatement of the underwriting agreement (A8-10).

Continental's wholly owned subsidiary, W&R/Mass,* thereupon issued the $80 tender offer required by the Continental Contract. That Contract, and the tender offer, were consummated on July 2, 1969; W&R Mass acquired more than 98% of the outstanding stock of W&R/NY at an aggregate price of about $80 million; and the management of the Fund reinstated the service agreements (A10-11).

It is plaintiffs' claim that these transactions constituted a sale to Continental and W&R/Mass of W&R/NY's fiduciary positions as investment adviser and principal underwriter, in violation of the Act and the common law. See Rosenfeld v. Black, supra, 445 F. 2d 1337 (2d Cir. 1971).** The $62 million excess of the $80 million purchase price over the $18 million net asset value of the stock constituted payment for the fiduciary offices. The defendants other

*W&R/Mass was originally called CWR Corporation. It assumed its present name upon the merger into it of W&R/NY on December 31, 1969 (A5-6).

**The rule of Rosenfeld has since been modified by statute, but without retroactive effect. Section 15(f) of the Act, 15 USC § 80a-15(f), as amended June 4, 1975, 89 Stat. 164-65.

than the Fund are jointly and severally liable for the $62 million (A 11-12).*

3. Defendants' motions for summary judgment.

Defendants' motions (A58, 268) asserted that the present sale-of-office claim is barred by a judgment and release issued in the Horenstein-Ruskay actions.** These were stockholders' derivative suits on behalf of the Fund; they involved substantially all of the present defendants.+ The moving and opposing affidavits (A65, 275, 422) presented extensive documentation from Horenstein-Ruskay. The documents as such are uncontroverted; but since their import is in dispute, a somewhat detailed review is necessary.

4. The Horenstein action.

(a) The original Horenstein claim.

The Horenstein action was commenced on October 26, 1967 (A277). An amended complaint was filed on June 13, 1968 (id.).

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*An allegation that the proxy statement was materially false (A12-13) has been abandoned.

**Horenstein et al. v. Waddell & Reed, Inc. et al. (S.D.N.Y., 67 Civ. 4175); Ruskay v. Merriman et al. (S.D.N.Y., 69 Civ. 276).

+Mr. Valicenti, a defendant here, was not a defendant in Horenstein-Ruskay, but we make no point of this.

still long before the events of 1969 involved in the present actions. The Horenstein amended complaint (A84) alleged that, from 1965 to 1968, the defendants breached their fiduciary duties to the Fund by channeling its portfolio securities transactions to a subsidiary of W&R (Kansas City Securities Corporation, or "KCSC"), which acted as stock broker for the Fund; in this connection, W&R and KCSC engaged in various improper practices resulting in detriment to the Fund and large illegal profits to KCSC and W&R.

Plainly these alleged brokerage abuses have no relation to the claim here pursued. Their subject matter was different and they referred to an earlier period of time.

(b) The Horenstein supplemental complaint.

This complaint was filed on June 5, 1969 (A78, 107) pursuant to leave granted by Judge Tyler's decision of May 26, 1969 (A338). The same decision also consolidated the Horenstein and Ruskay actions (ibid.). The relevant facts pertaining to the supplemental complaint are these:

1. On February 4, 1969, Horenstein moved by order to show cause (A280) for leave to file a second amended (actually a supplemental) complaint. This proposed pleading (A289) stated three counts. The first realleged the brokerage abuses (A289-305). The second (A305-07) was disallowed by Judge Tyler because it was unconnected with the brokerage abuses (A338, 343-44). The third

proposed count (A308-09) ultimately became, verbatim, the second count of Horenstein's supplemental complaint (A107-110). It is this count which, according to defendants, furnishes the basis for the plea of res judicata.

The third proposed count (A308-09), like the supplemental complaint itself (A107-110), realleged the brokerage abuses and added: On or about January 30, 1969, defendants Waddell and Merriman, controlling stockholders of W&R, agreed to sell their stock in W&R to Continental at $80 per share (A107, 306). The directors of the Fund and of W&R approved a proposed tender offer by Continental for more than 80% of W&R's outstanding stock (A107, 306). The consummation of the sale would transfer control of W&R to Continental (A108, 306). Waddell and Merriman agreed to the sale with an eye to their personal profit and in disregard of their fiduciary and legal obligations to the Fund and its shareholders; the Fund, KCSC and Roach acted in concert with them (A108, 307). The high price to be paid by Continental for the W&R stock was due to W&R's record of steadily growing earnings; the earnings growth, in turn, was due in large part to the unlawful brokerage practices (A108-09, 308). "Therefore", a substantial portion of the price to be paid for the W&R stock rightfully belonged to the Fund (A109, 308).

The supplemental complaint thus did not charge a sale

of the advisory and underwriting offices of W&R. Nor did it allege the facts necessary to support such a charge. It did not allege that the sales price exceeded the net asset value of the W&R stock;* or that the service agreements terminated by reason of the stock sale; or that the sale was conditioned upon the reinstatement of the service agreements by the stockholders and directors of the Fund; or that the sellers and management undertook to and did secure the reinstatement. In the absence of these allegations, Horenstein's supplemental complaint did not assert even the germ or semblance of a sale-of-office claim.

What the supplemental complaint did allege was no more than that the $80 price to be paid for the W&R stock was, in part, an outgrowth of the defendants' unlawful brokerage practices. Horenstein had already claimed that W&R's profits from those practices belonged to the Fund; the supplemental complaint merely added that those profits included that part of the $80 price which reflected the increase of W&R's earnings due to the brokerage abuses. As the Court below put it, the supplemental complaint -

> "alleged that the price [for the W&R stock] was largely a result of the ability of the investment adviser of United [i.e., the Fund] to earn substantial illegal profits in its management of the fund, as alleged in

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*A sale of the W&R stock at actual net asset value would not have involved the payment of a price for the offices and would, therefore, have been altogether legitimate under the Rosenfeld doctrine.

the principal complaint. It was claimed that these illegal profits resulted from a breach of fiduciary duty, and therefore the premium paid for them was rightfully the property of United." (A445; interpolations added]

2. The Horenstein parties - plaintiffs as well as defendants - advanced the same analysis. So did Judge Tyler in granting leave to file the supplemental complaint.

Thus the statement (affidavit) of defendants' counsel, Mr. Jordan, referred to the proposed third cause of action (which later became the supplemental complaint) as follows (A318, 331):

> "As a third cause of action, plaintiffs allege that the high price being paid to the defendants, including Merriman and Waddell, is the result of profits accrued to W&R and KCSC through the acts and practices presently [i.e., in the then current amended complaint] complained of." (A318)

> "*** the factual issue tendered by plaintiffs' new third cause of action is the extent to which the price they [Waddell and Merriman] may have agreed to accept for their shares is related to profits alleged to have accrued from the activities challenged in the present causes of action." (A331; interpolations added)

Defendants thus clearly understood that the proposed third cause of action referred to the sale of the W&R stock only on the theory that the sales price reflected in part the defendants' unlawful profits from the alleged brokerage malpractices.

Counsel for the Horenstein plaintiffs agreed with this characterization (A334):

> "Here too, the underlying facts relating to this claim are identical with the facts pleaded in the original

cause of action. Here too, all that plaintiffs seek by the amendment is the broadening of relief to cover the circumstance created by the defendants' plan to transfer control of WRI [i.e., W&R]. In this connection, the third cause of action merely adds the allegation that a substantial portion of the proposed purchase price per share of WRI stock is attributable to the earnings reflected by the profits received by KCSC ***." (Emphasis and interpolation added)

Judge Tyler's decision of May 26, 1969 adopted this interpretation of the new Horenstein claim (A340):

"The third cause of action re-alleges the paragraphs of the first two causes of action, and also alleges the following: that a substantial portion of the value of the W & R shares being sold is attributable to the gains of W & R from the illegal practices alleged in the first cause of action; that this increment is an asset of United; and that the present shareholders of W & R, including defendants Merriman and Waddell, are about to convert this asset to their own use." (Emphasis added)

Judge Tyler thus permitted the supplemental complaint on the premise that it still alleged no more than the old claim for brokerage abuses, and that only the relief sought was broadened.

Equally important, for present purposes, is Judge Tyler's denial of leave to plead the proposed second cause of action, which had no connection with the alleged brokerage abuses and was, therefore, as the Court held, not within the pendent jurisdiction of the Court (A343-44). The Court added: "Moreover, if I am in error on this point and the court does have such power, I find that the interests of judicial economy and fairness to litigants would not

be served by adding this claim to either the Horenstein action or the consolidated [Horenstein-Ruskay] actions" (A344).

Judge Tyler was thus unwilling to permit a claim to be pleaded that was not based upon the alleged brokerage abuses. The sale-of-office claim has no relation to those abuses. Had leave to plead the sale-of-office claim been sought, it is thus more than doubtful whether Judge Tyler would have granted it. As noted, the burden of proof on that question rests on defendants.

The Horenstein complaint, as amended and supplemented, was finally replaced by a "Second Verified Amended Complaint" (A237), without any change here relevant.*

5. The prior Ruskay action

The Ruskay action was commenced on January 23, 1969, prior to any of the events involved in the present suits.** The complaint alleged the same brokerage abuses as the amended Horenstein complaint, with some further details added (A156).

Upon consolidation of Horenstein and Ruskay and the filing of the Horenstein supplemental complaint on June 5, 1969, Ruskay

*This new complaint was filed, on the eve of the Horenstein-Ruskay settlement, pursuant to a stipulation of December 15, 1969 (A439). It simply repeated the claims previously alleged (A237, 253) and added a third count (A255), which has no bearing on the present controversy.

**The plaintiff in Ruskay was the same Sophie Ruskay who is the plaintiff in one of the four present actions. Her present attorneys had no connection with the prior action.

followed Horenstein's example. By order to show cause of June 16, 1969, she moved for leave to file a supplemental complaint substantially identical with the Horenstein supplemental complaint (A345, 352). Ruskay's moving papers expressly invoked Judge Tyler's decision of May 26, 1969 in Horenstein as authority and acknowledged the similarity of the supplemental complaints in the two cases (A349). Ruskay's motion was granted by a consent order of July 2, 1969 (A355), and her supplemental complaint was filed on July 7, 1969 (A172). It added nothing to Horenstein's supplemental complaint. What we have said concerning the latter applies equally to Ruskay's supplemental complaint.

6. The Horenstein-Ruskay settlement.

On December 24, 1969, the Horenstein-Ruskay parties entered into a settlement stipulation (A197), by which the defendants agreed to pay the Fund between $535,000 and $650,000 in settlement of the actions. The settlement was submitted to Judge Lasker for his approval. After notice to the stockholders of the Fund (A203) and a hearing, Judge Lasker approved the settlement by his decision of May 26, 1970 (A207). A judgment dismissing the actions with prejudice was entered June 25, 1970 (A228). Releases in the form provided by the settlement stipulation were executed by the Fund on October 6, 1970 (A234).

Throughout the settlement proceedings, all parties were

in agreement that the claims alleged in the supplemental complaints were based upon the brokerage abuses. They so informed the stockholders of the Fund, and they so advised Judge Lasker.

Thus the settlement notice to the stockholders of the Fund summarized the brokerage charges of the Horenstein-Ruskay complaints and went on to state (A205):

> "By supplemental complaints filed by the Horenstein plaintiffs on June 5, 1969 and by the plaintiff in the Ruskay action on July 7, 1969, it is alleged that the defendants Waddell, Merriman and Roach arranged to sell a majority of the voting shares of W&R held by themselves and members of their families at a price of $80 per share; that such price was largely attributable to the profits derived by W&R from the acts, transactions and practices complained of in their principal complaints; and that the proposed sale should be enjoined or the proceeds thereof sequestered for the benefit of United. The defendants involved in such allegations have denied that they are accountable to United or its shareholders for the selling price of their W&R shares or that such selling price was dependent on or affected by any of the improprieties or wrongdoing alleged by plaintiffs; and that, after full disclosure on the matter, the shareholders of United, on June 3, 1969, approved the reemployment of W&R as investment adviser and manager of United in the event that control of W&R should be acquired by the purchaser of their shares."

The stockholders were thus informed that the supplemental complaints - just like the main complaints - were based on the alleged brokerage abuses. These were the claims to be settled. Not a single hint warned the stockholders that the settlement was intended - as defendants now contend - to bar a claim for the sale of W&R's advisory and underwriting offices. On the contrary, the stockholders' resolution of June 3, 1969 reinstating the advisory

contract was mentioned only as a matter of affirmative defense.

Similar representations were made by the parties to Judge Lasker. Thus defense counsel's statement (affidavit) in support of the settlement (A403), after summarizing the alleged brokerage abuses, described the supplemental complaints as charging no more than that the $80 price to be paid for the W&R stock -

> "reflected, in effect, a self-serving capitalization of the improper and illegal profits being earned by KCSC as a result of the matters and transactions previously alleged." (A409)

Defendants' brief in support of the settlement contained a similar characterization of the supplemental complaint (A434).

The settlement brief for the Horenstein-Ruskay plaintiffs (A357, 401) went even further. After depicting the obstacles to recovery on the brokerage charges (A372-88), the brief stated that the supplemental complaint had been brought merely "to safeguard the recovery" on the brokerage claims (A388). The brief went on (A389):

> "The issue raised by the supplemental complaint has become moot and is not a factor to be considered by the Court in passing upon the proposed settlement. In June, 1969, the sale was consummated and approved by United shareholders who also approved continuation of the Investment Management Contract. Moreover, there is no longer any need to secure any recovery since the proposed settlement makes adequate provision for payment of the $650,000." (Emphasis added)

It is difficult to imagine a sharper refutation of defendants' present contentions. The consummation of the stock

sale and the reinstatement of the advisory contract are an essential basis of the present claim for the sale of office. But these very events, Judge Lasker was told, rendered the Horenstein-Ruskay supplemental complaints moot. Inevitably, therefore, the sale-of-office claim was not part of the Horenstein-Ruskay pleadings and was not included in the Horenstein-Ruskay settlement.

Judge Lasker's decision approving the settlement (A207)* reflects the same analysis of the pleadings and of the scope of the settlement. The decision painstakingly summarized and analyzed the brokerage charges and their meager prospect of success (A210-11, 214-20), the terms of the settlement (A212-13), and the several objections to its approval (A220-24). By contrast, the decision barely mentioned the existence of the supplemental complaints (A210), and devoted not a single word to their content, let alone to their merit.

There is only one explanation for this silence of the otherwise detailed and exhaustive decision: Judge Lasker read the supplemental complaints as merely seeking additional relief for the brokerage abuses. On that premise, it was enough to show that the brokerage charges were weak, as Judge Lasker found them to be. But this treatment would have been impossible if Horenstein-

*The decision is reported, Horenstein v. Waddell & Reed, Inc., '69-'70 CCH Fed. Sec. L. Rep. ¶ 92,678 (S.D.N.Y. 1970).

Ruskay had involved an independent claim for the sale of W&R's offices. Such a claim would not have been affected even by the complete absence of any brokerage abuses. Judge Lasker's failure to discuss any sale-of-office claim thus demonstrates that he - like the parties themselves and like Judge Tyler's earlier decision - found no such claim anywhere in the Horenstein-Ruskay pleadings. The present defendants' contrary interpretation of those pleadings is just an afterthought.

POINT I

RES JUDICATA IS NO DEFENSE BECAUSE THE CLAIMS HERE AND IN HORENSTEIN-RUSKAY ARE NOT THE SAME.

Res judicata bars a claim only if it is "the same" as the claim adjudicated in a prior action.* Commissioner v. Sunnen, 333 U.S. 591, 597 (1948); Lawlor v. National Screen Service Corp., 349 U.S. 322, 326 (1955); Herendeen v. Champion Int'l Corp., 525 F. 2d 130, 133-35 (2d Cir. 1975); 1B Moore's Fed. Prac. (2d Ed. 1974), ¶ 0.410[1], pp. 1151 et seq. We submit, contrary to the Court below, that the causes of action here and in Horenstein-Ruskay do not have "the requisite measure of identity *** to support the trial court's

*Res judicata proper differs, in this respect, from collateral estoppel, which does not require identical claims. Defendants' motions invoked collateral estoppel (A60), but the Court below rightly held that it is not here involved (A446).

finding of res judicata"; Herendeen, supra, 525 F. 2d at 133.

1. To begin with, it is plain that the Horenstein-Ruskay supplemental complaints did not allege a claim for the sale of W&R's offices. The Court below did not so read them (A444-45); nor did the parties and the Court in Horenstein-Ruskay. The supplemental complaints referred to the sale of the W&R stock only because part of the $80 price allegedly was "the result of" (A108,318), or "attributable to" (A173, 205, 340), or a "capitalization of" (A409, 447), W&R's improper and illegal brokerage profits. This was the ground on which Horenstein and Ruskay sought to impress a trust on the sales proceeds. Not a word suggested that the price included payment for the transfer of the advisory and underwriting offices.

Defendants contend, nevertheless, that the difference of the present actions from Horenstein-Ruskay is mere "rhetoric and terminology" (A425). The simple answer is that Horenstein-Ruskay failed to allege not just the theory, but the facts essential to support a claim for the sale of office (see pp. 12-13, above).

Defendants (A425) rely on paragraph 67 of the Horenstein supplemental complaint, which recited (A108):

> "67. With an eye toward their own personal profit and aggrandizement, and in total disregard of their fiduciary and legal obligations to United and United's shareholders, the Defendants Waddell and Merriman have agreed to and are preparing to sell their controlling stock to Continental, and the Defendants United, KCSC, and Roach have

acted and continue to act in concert with Waddell and Merriman to facilitate such sale and to facilitate Continental's tender offer for the remaining outstanding shares of WRI."

The bare allegation that the stock sale was in disregard of defendants' fiduciary and legal obligations was a plain conclusion of law, meaningless without supporting allegations of fact. The sale of the W&R stock, standing by itself, was completely innocuous; simply calling it a breach of fiduciary duty did not make it so. The fact allegations showing a fiduciary breach were in other paragraphs (A108-109), and those referred to the brokerage abuses, not to a sale of office. The same observation applies to defendants' reliance (A426) on the conclusory allegations of paragraph 35 of the Ruskay supplemental complaint (A173). Neither paragraph 67 of Horenstein nor paragraph 35 of Ruskay, nor any other part of their pleadings, suggested that a sale of office was alleged.

2. The absence of that allegation in Horenstein-Ruskay is not, of course, the end of the matter. For res judicata purposes, the claims in two successive actions may be "the same" even though different grounds for the claim are alleged.* Before discussing

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*Thus two actions by a seaman for the same personal injury suffered in the same incident were held to involve "the same" claim although negligence was in one action predicated on the use of defective appliances, in the other on the improper operation of the appliances; Baltimore Steamship Co. v. Phillips, 274 U.S. 316

(Footnote continued on following page)

the criteria bearing on the identity or difference of the causes of action here and in Horenstein-Ruskay, it is necessary to develop the nature of the claim at bar in light of this Court's decision in Rosenfeld v. Black, supra, 445 F. 2d 1337.

Rosenfeld, like the present action, involved a claim for the sale of an investment adviser's office. This Court started from the well established principle of equity that "a personal trustee, corporate officer or director, or other person standing in a fiduciary relationship with another, may not sell or transfer such office for personal gain" (445 F. 2d at 1342). An investment adviser is a fiduciary within the scope of this principle (pp. 1342-43). Of course, an investment adviser, just like an executor or a trustee or a corporate director, cannot directly assign his office to another (p. 1344); but he can bring about a transfer of the office by inducing the stockholders to appoint his chosen successor (ibid.). It is this use of influence with the stockholders for which the adviser, as fiduciary, must not accept personal gain (445 F. 2d at 1342, 1347 n. 13):

(Footnote from previous page continued)

(1927). Similarly, two antitrust suits alleging the same transaction were held to involve "the same" claim even though one suit was based on the Sherman Act and the other on the Clayton Act; Williamson v. Columbia Gas & Elec. Corp., 186 F. 2d 464 (3rd Cir. 1950), cert. denied, 341 U.S. 921 (1951).

> "A fiduciary endeavoring to influence the selection of his successor must do so with an eye single to the best interests of the beneficiaries. *** the only certain way to ensure full compliance with that duty is to eliminate any possibility of personal gain." (p. 1342).
>
> * * *
>
> "The prime vice in the realization of profit by an investment adviser or a controlling shareholder from a would-be successor lies in the danger that in return for this he may exert his influence to secure stockholder approval of the new or reinstated [advisory] contract when that may not be the best possible course." (p. 1347 n. 13; interpolation added).

Since the transfer of a fiduciary office for personal gain is prohibited, a fiduciary receiving such gain must surrender it to his beneficiary.

The Rosenfeld principle does not rest on any theory that a fund has a proprietary interest in the office or in the current or prospective fees of its adviser. The defendants in Rosenfeld contested liability because the prospect of future fees was an asset of the adviser (Lazard), not of the fund; but this Court held the point to be immaterial (p. 1343):

> "It is wholly immaterial that the prospect of receiving future management fees if it [Lazard] had continued as an adviser would have been an asset of Lazard rather than of the Fund; the same would be true of a trustee's right to receive future commissions or a corporate president's right to receive future salary and other benefits." (Interpolation added).

In the present case, as in Rosenfeld, the advisory and underwriting offices, and the prospective income therefrom, were the property of the adviser, here W&R, and its stockholders. The

vice in the stock sale was not that it disposed of an asset of the Fund, but that the sellers, for personal gain, undertook to and did procure the reinstatement of the service agreements by the stockholders and directors of the Fund. Such being the nature of the claim at bar, we proceed to show that, by any applicable test, the claim here is altogether "different" from the Horenstein-Ruskay claim.

3. "The test for determining whether causes of action are the same for purposes of res judicata has been variously expressed"; Herendeen, supra, 525 F. 2d at 133. The Court below followed the statement in Baltimore Steamship Co. v. Phillips, 274 U.S. 316, 321 (1927), that "[t]wo causes of action are the same if they allege 'the violation of but one right by a single legal wrong'" (A446).

The application of this test to the present case indicates the difference rather than the identity of the claims. The right allegedly violated in Horenstein-Ruskay was the right of the Fund to the proper management of its portfolio brokerage business; the wrongs complained of were a series of allegedly improper portfolio transactions caused by the defendants from 1965 to 1968. On the other hand, the right allegedly violated in the present case is the right of the Fund and its stockholders to pass on the reinstatement of the service agreements under the guidance of an investment adviser uninfluenced by personal gain (Rosenfeld, 445 F. 2d at 1345);

and the wrong complained of is the use by defendants, for private gain, of their fiduciary influence to secure the reinstatement of the service agreements in 1969. The two cases thus involve altogether different rights, violated by entirely separate wrongful acts.

Judge Metzner held that the "single legal wrong" in both cases was "the breach by defendants of their fiduciary duty to refrain from making personal profits upon a sale of assets properly belonging to [the Fund]" (A446-47). This, we submit, misconceived the nature of the claim at bar. The present plaintiffs do <u>not</u> contend that the advisory and underwriting offices, of whose sale they here complain, "properly belonged to the Fund"; on the contrary, <u>Rosenfeld</u> expressly rejected the idea that a sale of the advisory office involves the sale of an asset of the fund (445 F. 2d at 1343).

Even less helpful to defendants is the test which the Court below derived from <u>Saylor v. Lindsley</u>, 391 F. 2d 965, 969 n. 6 (2d Cir. 1968). Under that test, the claims involved in two lawsuits are the same if they "depend on the same operative facts and pertain to the same disputed transactions" (A446). The "operative facts" on which the <u>Horenstein-Ruskay</u> claim depended were the brokerage abuses. By contrast, the "operative fact" on which the present claim depends is the use by defendants, for private gain, of their influence with the stockholders and directors of the Fund to secure the reinstatement of the service agreements. The "disputed

transactions" here and in Horenstein-Ruskay differ for the same reason. The Saylor test thus refutes rather than supports the supposed identity of the Horenstein-Ruskay claim with that at bar.

The other tests listed in Herendeen, supra (525 F. 2d at 133-34), point in the same direction. One of them finds identity of claims where "a different judgment in the second action would impair or destroy rights or interests established by the judgment entered in the first action" (p. 133). The Horenstein-Ruskay judgment approved the settlement of that case because the likelihood of recovery on the alleged brokerage abuses was small (A214-20, 224). The rights and interests established by this decision would certainly not be impaired or destroyed by a decision in the present case that defendants improperly accepted payment for securing the reinstatement of the service agreements.

Another test approved by this Court in Herendeen (525 F. 2d at 133) holds that claims are identical if the second claim requires "the same evidence" as the first.* Evidence of the

*Judge Metzner thought that the "same evidence" test is valid only as a positive, but not as a negative test for determining the identity of claims (A447-48). He did not, however, have the benefit of this Court's decision in Herendeen which, on the strength of the "same evidence" test, concluded "negatively" that the claims in the first and second suits were not identical (525 F. 2d at 135). For other authorities see: United States v. The Haytian Republic, 154 U.S. 118, 125 (1894); Woodbury v. Porter, 158 F. 2d 194, 195 (8th Cir. 1946); Freeman on Judgments (5th Ed. 1925), § 687, pp. 1447-50.

brokerage abuses, a necessary element of proof in Horenstein-Ruskay, is obviously not required to sustain the present claim for the sale of office. Conversely, a proof of the sale of office would not establish the brokerage abuses. The evidence necessary to maintain the present action is thus wholly different from the evidence that was required in Horenstein-Ruskay.

4. Herendeen, supra (525 F. 2d 130), this Court's most recent decision on res judicata, presents important analogies to the case at bar. The plaintiff there, a former employee of the defendant, sued to recover payments allegedly due him under the defendant's pension plan. In an earlier state court action, which was dismissed, he had sought damages because the defendant had fraudulently induced him to resign his employment and thereby to forfeit his pension rights. This Court rejected the defense of res judicata because the fraud claim in the first action was not "the same" as the pension claim in the second. Although both actions referred to the plaintiff's loss of the pension plan benefits, the earlier suit mentioned it "only as an element of all the damages plaintiff allegedly suffered as a consequence of the fraud" (p. 134). Horenstein-Ruskay similarly referred to the proceeds from the sale of the W&R stock only as an element of the profits they sought to recover from defendants. Here, as in Herendeen, this sort of reference does not support a plea of res judicata.

Herendeen also supplies the answer to Judge Metzner's assumption - unsupported by the record - that the Horenstein-Ruskay plaintiffs "consciously avoided" asserting the sale-of-office claim because, in the light of SEC v. Insurance Securities, Inc., 254 F. 2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958), they considered the claim as "doubtful" (A447).* We submit, to the contrary, that the sale-of-office claim, not being "the same" as any of the Horenstein-Ruskay claims, could be omitted, consciously or otherwise, from Horenstein-Ruskay without any adverse res judicata consequences. The defendants in Herendeen argued that the plaintiff could have presented his pension claim in the earlier state court action and that the judgment in that action was conclusive upon him not only as to the claims which were there adjudicated, but also as to those which could have been (p. 134). This contention, however, was rejected because the claims in the two actions were not the same. The "plaintiff in his second suit has set forth an independent claim of defendant wrongdoing. *** Although in the state suit [plaintiff] could have joined the present cause of action along

*Our review of "[t]he memoranda submitted in support of the proposed [Horenstein-Ruskay] settlement" nowhere indicates "plaintiffs' recognition that the Insurance Securities case made recovery on the supplemental complaints doubtful" (A447; emphasis added). The only reference to that case we have found is in a memorandum of defendants (A434).

with his claim that defendants misled him fraudulently when he resigned, he was not compelled to do so" (pp. 134, 135). The present action, likewise, sets forth "an independent claim of defendant wrongdoing", which did not have to be asserted in Horenstein-Ruskay and is, therefore, not barred by the judgment in that case.*

Herendeen answers yet another argument of the decision below. Judge Metzner held that "[i]f the plaintiffs here were to be successful in their claims, [the Fund] would be recovering the same premium twice" (A447). A similar problem, however, existed in Herendeen. If the plaintiff there, in his earlier fraud action, had recovered damages for the loss of his pension rights, a recovery by him in his second suit based on the pension plan would likewise have been duplicatory. Nevertheless, this Court rejected res judicata because the claims were not the same. Herendeen thus establishes that claims which are otherwise separate and distinct do not become a single claim just because the recoveries overlap.**

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*It is, of course, settled law that a prior judgment does not bar a separate and distinct claim even though, under the liberal rules of joinder, that claim could have been asserted in the earlier action. United States v. The Haytian Republic, supra, 154 U.S. at 125; Forrest Village Apartments v. United States, 371 F. 2d 500, 503-04 (Ct. Cl. 1967); 1B Moore's Fed. Prac. (2d Ed. 1974), ¶ 0.410[1], pp. 1151-52.

**Duplication of recovery could have been readily avoided in Herendeen by deducting any recovery realized in the first action from the amount found due in the second.

Actually, the record does not show that a recovery here would involve any duplication of the Horenstein-Ruskay settlement. Under the settlement stipulation (A197), W&R (or its subsidiary, KCSC) was to pay $500,000 in five annual instalments; unnamed "defendants" were to pay, or cause to be paid, an additional $150,000 upon the consummation of the settlement (A199). Since W&R (or KCSC) was the direct beneficiary of the alleged illegal brokerage profits, it stands to reason that the additional $150,000 was likewise paid by W&R; in any case, defendants, who have the burden of establishing res judicata, McNellis v. First Federal S. & L. Ass'n, 364 F. 2d 251, 257 n. 8 (2d Cir.), cert. denied, 385 U.S. 970 (1966), have not shown otherwise. The recovery in the present case depends on the amount (about $80 million) paid by Continental for the W&R stock and on the excess of that amount over the $18 million net asset value of that stock. Neither of these figures is affected by the payment which W&R (or KCSC) made under the Horenstein-Ruskay settlement. But even if $150,000 of the settlement had been paid by the selling stockholders, the result would only be to reduce the net sales price ($80 million) by the amount of the $150,000 payment. If such a deduction should be in order, it will be time to provide for it in fashioning the relief to be awarded in this action.

5. Despite all the technicalities of res judicata, the application of the doctrine must, in the last analysis, be governed

by a dose of common sense. Suppose that the Horenstein-Ruskay actions had gone to trial and had resulted in a complete exoneration of defendants from any brokerage abuses. The judgment of dismissal would then have denied all the relief sought by the plaintiffs, including the relief sought by the supplemental complaints. Can it be seriously contended that such a judgment would shield defendants from liability for the sale of their offices to Continental? The mere suggestion borders on the absurd. Absolution from one wrong, the alleged brokerage abuses, cannot confer immunity from liability for a wholly different wrong, the sale of office. And, by the same token, a finding of liability for one wrong cannot extinguish liability for an altogether different wrong.

We submit that the identity of claims requisite for res judicata is here missing.

POINT II

RES JUDICATA IS NO DEFENSE BECAUSE THE SALE-OF-OFFICE CHARGE COULD NOT HAVE BEEN ASSERTED IN HORENSTEIN-RUSKAY.

The following discussion assumes, arguendo, that the causes of action alleged here and in Horenstein-Ruskay are "the same". The assumption brings into play the familiar rule that, if the causes of action are the same, "the judgment or decree upon the merits in the first case is an absolute bar to the subsequent action *** not only in respect of every matter which was actually offered and received to sustain the demand, but also as to every ground of recovery which might have been presented"; Baltimore Steamship Co. v. Phillips, supra, 274 U.S. 316, 319 (1926; emphasis added); Cromwell v. County of Sac, 94 U.S. 351, 352-53, 24 L. Ed. 195, 198 (1977); 1B Moore's Fed. Prac. (2d Ed. 1974), ¶ 0410[2], p. 1163. In other words, a plaintiff cannot "split" a single cause of action; he must assert all grounds of recovery available to him, failing which the ground he omits will be barred (Baltimore Steamship, supra, at 320; Moore's supra, at pp. 1163 et seq.). It follows, in the present case, that the sale of office is barred as a ground of recovery provided that it "might have been presented" in the Horenstein-Ruskay actions.

But could it have been presented?

If it could not, the rule against splitting is inapplic-

able, so that reliance on the sale of office is not barred by the *Horenstein-Ruskay* judgment. The authorities are unanimous that a prior judgment does not bar a ground of recovery which could not have been asserted in the earlier action.

International Railways v. United Food Co., 373 F. 2d 408, 417-19 (2d Cir.), *cert. denied*, 387 U.S. 921 (1967): A state court judgment awarding damages to a corporation for breach of the defendants' fiduciary duties did not preclude a second action by the corporation for violation of the antitrust laws, because the antitrust charge could not have been asserted in the earlier state court action for lack of jurisdiction (*semble*).

General Discount Corp. v. Sadowsky, 183 F. 2d 542, 546 (6th Cir. 1950): A state court judgment dismissing an action at law for damages for breach of contract did not preclude a second action in equity for reformation of the contract, because under the state law the equitable claim could not have been joined with the legal claim in the first action.

Taylor v. Continental Supply Co., 16 F. 2d 578, 581-82 (8th Cir. 1926): A state court judgment on a promissory note did not prevent a second action to

recover attorneys' fees under the terms of the note, because a state statute prevented the assertion of the fee demand in the first action.

American Standard, Inc. v. Crane Co., 60 F.R.D. 35, 39-40 (S.D.N.Y.), rev'd in part in other respects, 490 F. 2d 332 (2d Cir. 1973): A judgment dismissing an injunction suit under SEC Rule 10b-5 did not bar a later damage suit under the Rule because, at the time of the first action, the plaintiff was not yet a purchaser or seller of securities and, hence, could not have asserted the damage claim.

Accord: Burns Bros. v. The Central Railroad of New Jersey, 202 F. 2d 910 (2d Cir. 1953), discussed below.

Certainly the present sale-of-office claim could not be asserted in the original or amended Horenstein-Ruskay complaints. Those pleadings were filed prior to any of the events alleged in the complaints at bar. A judgment "cannot be given the effect of extinguishing claims which did not even then exist and which could not possibly have been sued upon in the previous case"; Lawlor v. National Screen Service Corp., supra, 349 U.S. 322, 328; International Railways v. United Fruit Co., supra, 373 F. 2d at 419.

Nor can it be assumed that the sale of office could have been pleaded in the Horenstein-Ruskay supplemental complaints.

It is true that, at the time these complaints were filed, the sale-of-office claim had accrued. Nevertheless, that claim could not have been included in the supplemental complaints without the permission of Judge Tyler. Under FRCP 15(d), the grant or denial of that permission, had it been sought, would have rested in Judge Tyler's discretion; 3 Moore's Fed. Prac. (2d Ed. 1974), ¶ 15.16[2], p. 1085. There is good reason to believe that Judge Tyler would have refused permission; for, as previously shown (pp. 15-16, above), he excluded from the supplemental complaint another proposed claim on the ground that it was not connected with the alleged brokerage abuses (A343-44).

It is, however, not even necessary to speculate whether or not Judge Tyler would have allowed the sale-of-office claim to be pleaded had he been asked for permission. Defendants have the burden of proof on that question, Burns Bros. v. The Central R.R. of New Jersey, supra, 202 F. 2d 910, 913; for the burden of showing the effect of a former adjudication is always on the party asserting the bar of res judicata. McNellis v. First Federal S. & L. Ass'n, 364 F. 2d 251, 257 n. 8 (2d Cir.), cert. denied, 385 U.S. 970 (1966), and cases cited. Defendants cannot sustain that burden, for it would manifestly be improper for them to inquire from Judge Tyler, and possibly from all other Judges then sitting in the District Court, what they would have done had the Horenstein-Ruskay plaintiffs asked for leave to allege the sale of office

in a supplemental complaint.*

A case on all fours is Burns Bros. v. The Central R.R. of New Jersey, 202 F. 2d 910 (2d Cir. 1953), in which Judge Learned Hand wrote the opinion for an unanimous court. In that admiralty libel case, a carfloat owned by the Central Railroad had broken from her moorings and had collided with and damaged a barge owned by Burns Bros. An in personam damage action brought by Burns against the Central Railroad had been dismissed for lack of negligence on the part of the Railroad. Burns then brought a second action, this time in rem against the carfloat; in that type of action proof of negligence was not necessary. The Central Railroad, as claimant, invoked the decree in the first suit as res judicata.

This Court held that the causes of action and the parties in the two suits were "the same"; the judgment rendered in the first action was, therefore, a bar to the second, provided that the remedy in rem "could have been" asserted in the prior suit. At the time of the first suit, however, the Central Railroad had been in bankruptcy reorganization, so that Burns could not have pro-

*An inquiry into the mental processes of a judge in arriving at his decision is improper, whether it be for res judicata purposes or any other purpose. United States v. Morgan, 313 U.S. 406, 421-22 (1941); Fayerweather v. Ritch, 195 U.S. 276, 306-07 (1904). A fortiori it would be improper to seek a judge's testimony as to his hypothetical decision of a motion that was never made.

ceeded in rem against the carfloat without the permission of the bankruptcy court. Burns never applied for that permission.

This Court held that, in these circumstances, the Central Railroad - as the party invoking res judicata - had the burden of proving that the bankruptcy court's permission would have been granted if it had been sought. Since the Central Railroad could not sustain that burden, the Court overruled the defense of res judicata (202 F. 2d at 913-14):

> "There can be no question that while the carfloat was in the possession of the New Jersey District Court in the reorganization proceeding of the Central Railroad, Burns Bros. could not have arrested her; the most that it could have done was to apply to that court for leave to do so; and it is impossible to know what would have been the result. On whom should the burden rest of proving that the reorganization judge would have granted such an application? It seems to us that it should rest upon the Central Railroad. As things stood, the remedy in rem was not 'available' to Burns Bros., and for that reason the decree in the first suit was not a bar."

The Burns Bros. case controls the case at bar. There, as here, res judicata depended on the plaintiff's ability to assert in the first action the claim which he advanced in the second. There, as here, the claim could have been asserted in the first action only with the discretionary permission of the court. There, as here, the plaintiff did not seek that permission, so that it was impossible to know whether it would have been granted if sought. In Burns Bros. this Court held that the burden of proving that the court would have granted permission - a burden

impossible to sustain - rested on the party invoking res judicata. By the same token, the present defendants bear the burden - impossible to sustain - of proving that Judge Tyler, or some other Judge, would have permitted the claim for the sale of office to be included in the Horenstein-Ruskay supplemental complaints. Under the rule of Burns Bros., and for the reasons above set forth, the plea of res judicata should be overruled.

POINT III

RES JUDICATA IS NO DEFENSE BECAUSE THE SETTLEMENT NOTICE IN HORENSTEIN-RUSKAY DID NOT INFORM THE STOCKHOLDERS OF THE FUND THAT A CLAIM FOR THE SALE OF W&R'S OFFICES WAS TO BE SETTLED.

The following discussion assumes, arguendo, that the effect of the Horenstein-Ruskay judgment is broad enough to embrace the sale-of-office claim. However, a judgment approving the settlement or dismissal of a stockholder's derivative action binds absent stockholders only if they received adequate notice of the proposed approval. The Horenstein-Ruskay settlement notice was inadequate because it failed to inform the stockholders that a claim for the sale of W&R's offices was to be settled and dismissed.*

*It is unnecessary to discuss whether plaintiff Ruskay can rely on this argument, since the three other plaintiffs were not parties to Horenstein-Ruskay and did not participate in the settlement proceedings.

1. Rule 23.1 FRCP provides that a stockholder's derivative action -

> "shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

A similar provision applies to the settlement of class actions; Rule 23(e) FRCP.

The requirement of a settlement notice is not only mandatory, Sertic v. Cuyahoga, Lake, etc. District Council, 459 F. 2d 579, 581-82 (6th Cir. 1972); Pittston Co. v. Reeves, 263 F. 2d 328, 329 (7th Cir. 1959), but is dictated by constitutional due process. Grunin v. International House of Pancakes, 513 F. 2d 114, 120 (8th Cir.), cert. denied, 423 U.S. 864 (1975); Greenfield v. Villager Industries, 483 F. 2d 824, 833-34 (3rd Cir. 1973); Milstein v. Werner, 57 F.R.D. 515, 518 (S.D.N.Y. 1972); Philadelphia Elec. Co. v. Anaconda Amer. Brass Co., 42 F.R.D. 324, 327 (E.D. Pa. 1967); see Eisen v. Carlisle & Jacquelin, 391 F. 2d 555, 564-65 (2d Cir. 1968); Advisory Committee Notes to Rule 23, 39 F.R.D. 107 (1966).

Although Rule 23.1, like Rule 23(e), leaves the mechanics of the settlement notice - its content, method and form - to the discretion of the district court, the exercise of that discretion is subject to the standards of reasonableness imposed by due process. Grunin, supra, 513 F. 2d at 121; Greenfield, supra, 483 F. 2d

at 833-34. An inadequate notice "may be as fatal to due process as no notice at all"; Greenfield, supra, 483 F. 2d at 834.

These fundamental requirements of a settlement notice have a direct bearing on the res judicata effect of a judgment approving the settlement of a derivative or class action. Unless the settlement notice is adequate, the corporation and its stockholders (or the class) are not bound by the judgment; Smith v. Alleghany Corp., 394 F. 2d 381, 391 (2d Cir.), cert. denied, 393 U.S. 939 (1968):

> "***where the notice and representation are adequate a settlement decree in a derivative suit - a true class action - is res judicata." (Emphasis added).

Accord: Stella v. Kaiser, 218 F. 2d 64, 65 (2d Cir. 1954), rehearing denied, 221 F. 2d 115 (1955), cert. denied, 350 U.S. 835 (1955); 7A C. Wright and A. Miller, Fed. Prac. & Proced., Civil (1972), § 1840, p. 440.

In Papilsky v. Berndt, 466 F. 2d 251 (2d Cir.), cert. denied, 409 U.S. 1077 (1972), an earlier stockholders' derivative action had been dismissed because of the plaintiffs' failure to answer interrogatories. In a second similar action, brought by other stockholders, this Court refused to give res judicata effect to the judgment in the first suit because the dismissal of that suit was governed by Rule 23.1 and notice of the proposed dismissal was not given to the stockholders. Since Rule 23.1 prescribes a notice for the settlement no less than for the dismissal of a stockholder's action, Papilsky establishes that a judicially approved derivative settlement without the requisite notice does not constitute res judicata against the corpoation and its other

stockholders.

2. The Horenstein-Ruskay settlement notice (A203, 205) has been quoted in pertinent part (p. 18 , above). It set forth the brokerage abuses alleged in the principal complaints and went on to summarize the supplemental complaints as alleging that three of the individual defendants had arranged to sell a majority of the voting shares in W&R held by them and their families, at $80 per share;* that this price was "largely attributable to the profits derived by W&R" from the brokerage malpractices alleged in the principal complaints; and that the proposed sale should be enjoined or the proceeds thereof sequestered for the benefit of the Fund. The settlement notice added that the defendants denied any liability for the selling price of their W&R shares or that such price was affected by the alleged brokerage abuses; and that the stockholders of the Fund, on June 3, 1969, had approved the reemployment of W&R as investment adviser of the Fund in the event that control of W&R should be acquired by the purchaser of the shares.

The notice thus failed to convey the slightest intimation that a sale-of-office claim was alleged or that the settlement would discharge such a claim. The sale of the W&R shares was referred to only because the $80 sales price was "largely attributable to" W&R's profits from the brokerage abuses. There was no

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*Significantly, the allegation, as summarized in the notice, was not that a majority of all outstanding voting shares of W&R was being sold - only a majority of the voting shares owned by the three sellers and their families.

statement that the shares were being sold for more than asset value, or that the sale was conditioned on the reinstatement of the service agreements, or that the sellers undertook to and did procure the reinstatement. The stockholders' resolution approving the reemployment of W&R as investment adviser was mentioned only as a matter of affirmative defense and as effective only "in the event that" control of W&R should be acquired by the purchaser of the shares. The notice, we submit, was plainly inadequate to inform the stockholders that a sale-of-office claim was to be discharged by the settlement.

The purpose of a settlement notice is not to serve as an empty ceremonial. It must inform the stockholders of the nature of the claims to be settled; for otherwise it is impossible for them to make even a preliminary evaluation of the fairness of the settlement or to decide whether they should engage in a further investigation and possibly to oppose the settlement. After all, Rule 23.1 is designed to provide against the danger of the loss of class rights. The right of the stockholders to object implies the right to know what is being given away - which of the rights of the class.

The authorities so hold: Papilsky, supra, 466 F. 2d at 258 ("notice enables other stockholders to intervene to protect the corporate claim and to continue the litigation if that seems advisable"); Levin v. Mississippi River Corp., 59 F.R.D. 353, 372-73 (S.D.N.Y.), aff'd on opinion below sub nom. Wesson v. Mississippi River Corp., 486 F. 2d 1398 (2d Cir.), cert. denied sub nom. Wesson v. Levin, 414 U.S. 1112 (1973) (settlement notice must inform

stockholders "of the nature of the pending action"); Milstein, supra, 57 F.R.D. at 518 (content of settlement notice must enable shareholders to rationally decide whether they should intervene in the settlement proceedings and to prepare their position; "a fair recital of the subject matter and proposed terms and opportunity to be heard are attributes of due process"); Fistel v. Christman, 133 F. Supp. 300, 302 (S.D.N.Y. 1955) (notice should "describe the nature of the action"); 7A C. Wright and A. Miller, Fed. Prac. & Proced., Civil (1972), § 1839, pp. 429-30.

The stockholders of the Fund were not notified that the Horenstein-Ruskay settlement would discharge a sale-of-office claim. Since they did not know of any such claim, they were in no position to evaluate whether it was fair to dismiss this $62 million claim, along with other substantial claims, for a settlement sum of $650,000. Their ignorance of the claim deprived them of any opportunity to intervene or to appear at the settlement hearing in order to call Judge Lasker's attention to the sale-of-office claim and to offer evidence in support thereof. In fact, no such contention or argument was advanced by any of the objectors to the settlement (see the summary of objections, A220-24). So far as the sale-of-office claim is concerned, the settlement notice thus did not fulfill its constitutional and statutory purpose. To that extent, therefore, it was insufficient to give res judicata effect to the judgment.

Indeed, the vice of the settlement notice goes even deeper. Before a court may approve a proposed settlement, it must evaluate

the probable merits of the action, based on a rational appraisal of the particular areas of doubt and uncertainty that affect the prognosis of recovery; Protective Committee v. Anderson, 390 U.S. 414, 424-25, 434 (1968). Since the parties to the Horenstein-Ruskay settlement had buried their ax, they could not be relied on to furnish the necessary evidence and arguments to the Court; those could come only from an objector. The settlement notice, however, prevented outside stockholders from objecting to the dismissal of the sale-of-office claim. As a consequence, Judge Lasker's decision (A207) addressed not a single word to that claim. A judgment so procured, we submit, cannot operate as res judicata barring the claim.

POINT IV

THE DEFENSE OF RELEASE IS UNFOUNDED.

1. The release (A234) which the Fund executed pursuant to the settlement is, by its very terms, inapplicable to the sale-of-office claim. It recites that the Fund releases the Horenstein-Ruskay defendants, their directors, officers, agents, employees, heirs, executors and assigns -

> "of and from any and all claims, demands or causes of action arising at any time from the beginning of the world to the date of these presents [which] the undersigned, its successors or assigns, had, now has or may hereafter have against the aforementioned released parties, or any one of more of them, for or by reason of any of the matters or transactions recited or described in the complaints, supplemental complaints and/or other pleadings filed by the plaintiffs in the above entitled actions ***." (A235; emphasis added)

The claim at bar does not arise "for or by reason of any of the matters or transactions recited or described in" the _Horenstein-Ruskay_ complaints or supplemental complaints. The supplemental complaints, to be sure, alleged the proposed sale of W&R shares at $80 per share. The stock sale as such, as alleged in _Horenstein-Ruskay_, did not, however, give rise to the sale-of-office claim asserted in the present actions. As previously shown (pp. 24-26, above), the sale-of-office claim arises from the use by defendants, for private gain, of their fiduciary influence with the stockholders and directors of the Fund to secure the reinstatement of the service agreements. The _Horenstein-Ruskay_ supplemental complaints did not allege that the service agreements were reinstated; they did not allege that defendants secured the reinstatement; and they did not allege that defendants were paid for doing so. On its face, therefore, the release does not cover the present claim for the sale of office.

2. Even if this conclusion could be in doubt, it is resolved by the settlement notice (A203). The notice recites that, upon the judicial approval and effectiveness of the settlement, the Fund -

> "will execute and deliver a release which will discharge all of the defendants of and from any further liability with reference to any or all of the matters or transactions described or referred to in the various pleadings by the plaintiffs." (A206)

The stockholders were thus told that the release would embrace only matters described in the plaintiffs' pleadings. In describing these pleadings, the settlement notice made no reference to a sale-of-office claim. The release cannot, therefore, be construed to include that claim.

CONCLUSION

The judgment of the District Court summarily dismissing the sale-of-office claim should be reversed and the case should be remanded for further proceedings against the remaining defendants.

Dated: August 4, 1976

Respectfully submitted,

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ANNEX

PROVISIONS OF INVESTMENT COMPANY ACT OF 1940

IN EFFECT IN 1969

ANNEX

Provisions of Investment Company Act of 1940
in Effect in 1969:

Section 2(a)(4), 15 USC § 80a-2(a)(4):

SEC. 2. (a) When used in this title, unless the context otherwise requires—

(4) "Assignment" includes any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but does not include an assignment of partnership interests incidental to the death or withdrawal of a minority of the members of the partnership having only a minority interest in the partnership business or to the admission to the partnership of one or more members who, after such admission, shall be only a minority of the members and shall have only a minority interest in the business.

Section 2(a)(9), 15 USC § 80a-2(a)(9):

(9) "Control" means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.

Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting se-

curities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of the voting securities of any company shall be presumed not to control such company. A natural person shall be presumed not to be a controlled person within the meaning of this title. Any such presumption may be rebutted by evidence, but except as hereinafter provided, shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested person. If an application filed hereunder is not granted or denied by the Commission within sixty days after filing thereof, the determination sought by the application shall be deemed to have been temporarily granted pending final determination of the Commission thereon. The Commission, upon its own motion or upon application, may by order revoke or modify any order issued under this paragraph whenever it shall find that the determination embraced in such original order is no longer consistent with the facts.

Section 15(a), (b) and (c), 15 USC § 80a-15(a), (b) and (c):

SEC. 15. (a) After one year from the effective date of this title it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and—

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.

(b) After one year from the effective date of this title, it shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract, unless in effect prior to March 15, 1940—

(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

(2) provides, in substance, for its automatic termination in the event of its assignment by such underwriter.

(c) In addition to the requirements of subsections (a) and (b) it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, except a written agreement which was in effect prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company.

Service of three ③ copies of the within
is admitted this 4th day of August 1976
Cole & Deitz at 1:25 P.M.
By: R.M. Berry

Attorneys for Defendants-Appellees Joe Jack Merriman, et al.

Sullivan and Cromwell P.D.

Attorneys for Defendant-Appellee Chauncey L. Waddell

Kelley Drye & Warren

Attorneys for Defendant-Appellee United Funds, Inc.